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UNCLAS SECTION 01 OF 02 ANTANANARIVO 000366

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STATE FOR AF/EPS AND AF/E - MBEYZEROV
USDOC FOR BECKY ERKUL - DESK OFFICER
TREASURY FOR FBOYE

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SUBJECT: MADAGASCAR: DOWNWARD ECONOMIC SPIRAL

ANTANANARI 00000366 001.2 OF 002

¶1. (SBU) Summary: Madagascar appears to be headed towards a serious recession, as diminished government spending, loss of investor confidence, flagging exports, and suspension of donor funds translate into a loss of jobs and a slowdown of GDP growth. In addition to increased poverty, the transition authority (HAT) could, over time, face serious problems in its ability to pay civil service and military salaries if tax revenues continue to fall, and donor funds remain suspended. End summary.

Budget Shortfalls Met By Slashing Spending

¶2. (SBU) Due to diminished tax and customs revenue (29 percent below target) and the suspension of donor funds, the Malagasy government is facing a serious budget crunch. In response, the government has cut virtually all spending except salaries and debt payments, but will still need to finance a deficit. As external funding from the IMF is no longer available, the government plans to increase domestic borrowing specifically for financing the budget deficit by 14 percent over initial projections during the latter half of
¶2009. (Note: This 14 percent estimate, along with the government's revised annual revenue projections detailed below (down only 18.8 percent) seems overly optimistic, given the actual figures for the first four months and the likelihood of continued political uncertainty through year-end. End note.)

- Domestic Tax and Customs Revenue for Jan - Apr: Target: 351 million USD; Actual: 248.7 million USD
- Domestic Tax and Customs Revenue projected for 2009: Original: 1.206 billion USD; Revised: 1.069 billion USD (Note: The downward revision is due mainly to a fall in customs revenue because of declining international trade and to the poor performance of the fiscal administration. End note.)
- Government Revenue from Foreign Aid projected for 2009: Original: 405 million USD; Revised: 232 million
- Government Expenditure projected for 2009: Original: 2.089 billion USD; Revised: 1.595 billion USD
- Projected domestic borrowing to finance 2009 budget deficit: Original: 103 million USD; Revised: 120 million USD
  (Note: Overall treasury bond issuance by the GOM is projected to increase by 34 percent compared to 2008 (from USD 657 million to 880 million) however most of this increase will be used to repay prior T-bonds, rather than finance the budget gap. End note.)

Source: GOM and World Bank data; USD calculations based on exchange rate of 1 USD per 1950 Ariary

GDP Growth Languishes as Job Losses Multiply

¶3. (SBU) Because of the compounded impact of the global financial and Malagasy political crises, the tourism, textile, shrimp, and construction sectors have reported thousands of job losses. Customs data indicate a 25 percent decline in the value of textile exports during the first quarter of 2009. Operators predict further declines due to falling global demand and the possible loss of eligibility for African Growth and Opportunity Act trade preferences for the U.S. market. The suspension of donor funds and government public investment (of which donor funds represented 75 percent) has produced a slowdown in construction and public works activities. The construction union has estimated that the crisis will cause a 40 percent loss of company turnover during the remainder of 2009.

Balance of Payments Concerns

¶4. (SBU) In early 2008, the local currency, ariary, was facing pressure to appreciate due to large capital inflows from the mining sector, donor funds, and booming exports. That trend began to reverse in the third quarter of 2008, as mining construction projects were completed and global export demand diminished, and it intensified in the first quarter of 2009 as foreign aid flows were cut. During the first quarter, Madagascar's main export staples -- textiles, shrimp, and vanilla -- were down 40 percent in value terms compared with the same period in 2008. Since the beginning of October 2008 to date, the ariary has lost almost twenty percent of its value vis-a-vis the U.S. dollar. This

depreciation has made Malagasy exports more competitive, however it has also increased inflationary pressure and raised the risk that the currency will excessively depreciate due a loss of confidence in the ariary. The Central Bank lacks sufficient foreign exchange to defend against this potential overshooting which could produce a balance of payments crisis.

Bright Spots, For Now: Banking, Inflation, and Agriculture

¶5. (SBU) Despite the economic turmoil, the banking system remains sound, with deposits holding steady. Inflation has been controlled, up by only 10.4 percent at the end of April year-on-year. The Central Bank has maintained prudent monetary policies and has even reduced its lending to the government by one percent since year-end 2008. The agricultural sector, which employs three-quarters of the population mainly in subsistence rice farming, is performing well this year due to fair weather conditions. (Note: The weather likely has more of an impact on island-wide poverty than the macroeconomic and governance conditions, which disproportionately impact urban dwellers. It is these urban dwellers, however, that are politically-active and may react negatively toward the transition government. End note.)

Comment

¶6. (SBU) While the calm of last two months may lead to an upswing for the tourism sector, exports and foreign investment are likely to continue their decline for the foreseeable future. As a result, customs revenues will remain low. If Madagascar enters into recession, tax revenues will further diminish due to the slowdown in the productive sectors. If the transition government does not move toward reinstituting democracy to regain donor funds, the GOM could eventually lack the capacity to pay civil servant and or security forces salaries. Most estimates here indicate that such a fiscal train wreck is many months away, and other factors could delay it further still. End comment.
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